IFRS

STAFF PAPER

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IASB® meeting

Project	**Post-implementation Review of IFRS 9—Classification and Measurement**
Paper topic	Contractual cash flow characteristics

CONTACTS	Uni Choi	uchoi@ifrs.org
	Laura Kennedy	lkennedy@ifrs.org
	Riana Wiesner	rwiesner@ifrs.org

Introduction

1. At this meeting, the IASB will discuss feedback to *Request for Information Post-implementation Review of IFRS 9—Classification and Measurement* (the RFI) on assessing a financial asset's **contractual cash flow characteristics**.

2. Agenda Paper 3B and Agenda Paper 3C provide a summary of feedback and staff analysis on the two main topics for which respondents asked application questions (ESG-linked features and contractually linked instruments).

3. This paper provides:

   (a) a reminder of the IFRS 9 requirements for assessing contractual cash flow characteristics;

   (b) a summary of general feedback and staff analysis of that feedback; and

   (c) a summary of specific feedback including application questions (other than those covered in Agenda Paper 3B and Agenda Paper 3C) and staff analysis of those questions.

4. Staff recommendations and a question for the IASB are provided on page 2.

Staff recommendations and question for IASB

5. This paper analyses six application questions raised by respondents on contractual cash flow characteristics. Based on the analysis this paper (follow links in table), the staff recommend the IASB take the following actions for those six questions:

Application question	Staff recommendation
A. whether a financial asset has non-recourse features	Consider with PIR analysis of CLIs because the questions are connected (see Agenda Paper 3C)
B. whether an entity needs to consider cash flows arising from bail-in legislation	Consider subsequent to further development in FICE project because the topic of the question is similar to the IASB's recent tentative decisions in the FICE project
C. whether interest rates that are contractually adjusted for inflation introduce leverage	Seek input from ASAF and Interpretation Committee members as to whether based on their experience this question could meet the criteria of the IFRS Interpretations Committee
D. whether interest rates including a government-imposed leverage factor are regulated interest rates	Seek input from ASAF and Interpretation Committee members as to whether based on their experience this question could meet the criteria of the IFRS Interpretations Committee
E. whether a prepayment feature includes reasonable compensation for early termination of the contract	No further action because the IASB was made aware of this question as part of the 2017 Prepayment Features with Negative Compensation project and outreach since indicates practice has established
F. whether particular types of interest rates include a modified time value of money element	No further action because the IASB was made aware of this question as part of the 2020 IBOR Reform—Phase 2 project and outreach since indicates practice has established

Question for IASB
Do you agree with each of the staff recommendations in the table above?

IFRS 9 requirements

The classification and measurement approach

6. IFRS 9 provides one classification approach for all types of financial assets, including those that contain embedded derivative features. Financial assets are therefore classified in their entirety rather than being subject to bifurcation requirements.

7. Two factors determine how financial assets are classified and measured:

   (a) the entity's business model for managing the financial assets; and

   (b) the contractual cash flow characteristics of the financial asset.

		Business model for managing financial assets		
		Hold to collect	**Hold to collect and sell**	**Other**
Contractual cash flow characteristics	**Solely payments of principal and interest (SPPI)**	Amortised cost	Fair value through OCI (FVOCI)	Fair value through profit or loss (FVPL)
	Other	FVPL	FVPL	FVPL

Contractual cash flow characteristics assessment

Overview

8. Only financial assets with SPPI cash flows can be subsequently measured at amortised cost or fair value through OCI depending on the business model in which the asset is held.

9. Often it will be readily apparent whether contractual cash flows are SPPI, but sometimes closer analysis is required. Paragraphs B4.1.7–B4.1.26 of IFRS 9 provide requirements and examples to support entities to assess whether contractual cash flows are SPPI.

What is 'principal'?

10. Paragraph B4.1.7B of IFRS 9 explains that principal is the fair value of the financial asset at initial recognition. The principal amount may change over the life of the financial asset (for example, if there are repayments of principal).

What is 'interest' on the principal amount outstanding?

11. Paragraph B4.1.7A of IFRS 9 explains that in a basic lending arrangement, consideration for the time value of money and credit risk are typically the most significant elements of interest. However, interest can also include a return for other basic lending risks (for example, liquidity risk), amounts to cover costs associated with holding the financial assets for a particular period of time and a profit margin. Contractual terms that introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, such as exposure to changes in equity prices, do not give rise to SPPI cash flows.

Specific guidance on assessing contractual cash flow characteristics

12. Paragraphs B4.1.8–B4.1.19 of IFRS 9 provide specific requirements and examples for assessing contractual cash flow characteristics, including:

    (a) modified time value of money;

    (b) non-recourse features; and

    (c) contractual terms that are 'de minimis' or 'not genuine'.

13. Paragraphs B4.1.20–B4.1.26 of IFRS 9 provide specific requirements for assessing the contractual cash flow characteristics of contractually linked instruments (tranches).

Why SPPI?

14. SPPI cash flows are used as a basis for assessing whether a financial asset can be measured using amortised cost applying IFRS 9 because amortised cost is a relatively simple measurement technique. Amortised cost provides useful information about financial assets with relatively simple cash flows (ie solely payments of principal and interest on the principal amount outstanding), whereas fair value provides better information about financial assets with complex cash flows (for example, contractual

cash flows that are linked to an index and that can vary significantly from one period to another).

15. As explained in paragraph BC4.23 of the Basis for Conclusions on IFRS 9, the objective of the effective interest method for financial instruments measured at amortised cost is to allocate interest revenue or expense to the relevant period. Cash flows that are interest always have a close relation to the amount advanced to the debtor (the 'funded' amount) because interest is consideration for the time value of money and the credit risk associated with the issuer of the instrument and with the instrument itself. The IASB concluded that:
    (a) the effective interest method is not an appropriate method to allocate cash flows that are not principal or interest on the principal amount outstanding; and
    (b) if a financial asset contains contractual cash flows that are not principal or interest on the principal amount outstanding, a valuation overlay to contractual cash flows (fair value) is required to ensure that the reported financial information provides useful information.

Summary of general feedback

16. Most respondents shared the view that generally the contractual cash flow characteristics assessment works as intended. In their view, the requirements achieve the IASB's objective of providing users of financial statements with useful information about the amounts, timing and uncertainty of future cash flows. Some of these respondents expressed agreement with the IASB that it is appropriate to measure at fair value through profit or loss financial assets that do not have SPPI cash flows because fair value provides the most useful information for such financial assets.

17. A few respondents questioned whether measuring an entire financial asset at fair value through profit or loss provides the most useful information when the asset is 'held-to-collect' and generally has SPPI cash flows except for one minor feature that results in the contractual cash flows not being SPPI. A few of those respondents expressed the view that bifurcating such features (similar to previous IAS 39 requirements) could provide more useful information.

Staff analysis of general feedback

18. The staff note that the general feedback on the IFRS 9 requirements for assessing a financial asset's contractual cash flow characteristics is overall positive and is consistent with past feedback considered by the IASB.

19. With regards to feedback from a few respondents that said:

    (a) features that are 'minor' should not impact the SPPI assessment—the staff note that IFRS 9 includes the concept of 'de minimis' to ensure that a contractual feature does not affect the classification of a financial asset if the impact of that feature on the asset's contractual cash flows could only ever be de minimis. In the IASB's view, considering all other features (such as contingent features with a remote likelihood of occurrence) is consistent with its long-standing view that amortised cost provides relevant and useful information only for financial assets with simple contractual cash flows (see paragraph BC4.189 of the Basis for Conclusions on IFRS 9).

    (b) the bifurcation model for financial assets in IAS 39 could provide more useful information to investors—the staff note that this view conflicts with the view of other stakeholders that strongly supported to removal of bifurcation for financial assets. We also note that the IASB considered such views when it developed IFRS 9 and concluded that it would require a contract as a whole to be treated as the unit of account in IFRS 9 (see paragraphs BC4.89–B4.90 of the Basis for Conclusions on IFRS 9).

Summary of specific feedback

20. The majority of specific feedback related to two topics:

    (a) **ESG-linked features—**how to assess whether a financial asset has SPPI cash flows when the instrument has ESG-linked features (see Agenda Paper 3B for this meeting); and

    (b) **contractually linked instruments (CLIs)—**the scope of transactions to which the contractually linked instruments requirements apply and how to apply those requirements (see Agenda Paper 3C for this meeting).

21. Other specific feedback included questions on assessing whether:

    (a) a financial asset has non-recourse features, and distinguishing between credit risk and asset-performance risk when assessing whether a non-recourse financial asset represents an investment in particular assets;

    (b) an entity needs to consider the cash flows arising from bail-in legislation;

    (c) interest rates that are contractually adjusted for inflation introduce leverage;

    (d) interest rates including a leverage factor imposed by the government are considered regulated interest rates;

    (e) a prepayment feature includes reasonable compensation for the early termination of the contract; and

    (f) particular types of interest rates, for example compounded risk-free rates, include a modified time value of money element.

Staff analysis of specific feedback

22. The staff note that all of the specific feedback on contractual cash flow characteristics relates to application questions that have arisen in practice since IFRS 9 was issued. As noted by the IASB at its January 2022 meeting, a PIR is not intended to identify and resolve every application question. However, trends in application questions may identify the need for action.

23. Standard-setting, referring a question for consideration by the IFRS Interpretations Committee, and providing educational material are all further actions that the IASB could choose to take in response to application questions raised in the PIR. Whether to take further action, and what that action is, will depend on the IASB's analysis of the feedback.

24. With regards to educational material, the staff note:

    (a) educational material tends to be less visible than IFRS Accounting Standards or Agenda Decisions and may be more difficult for stakeholders to find or become aware of in the longer term. Therefore, educational material is often best suited when guidance is needed over a specified short-term period, (for example, supporting stakeholders to get to know a newly issued Accounting Standard) or to apply an Accounting Standard in a particular one-off circumstance (for example, the covid-19 pandemic).

(b) educational material is non-authoritative guidance. Therefore, educational material cannot substitute adding or changing requirements to an Accounting Standard or publishing an Agenda Decision.

25. With regards to referring an application question raised in the PIR to the IFRS Interpretations Committee, in deciding whether to discuss a question the Committee evaluates whether:

(a) the matter has a widespread or material effect;

(b) it is necessary to add or change requirements in IFRS Accounting Standards;

(c) the matter can be resolved efficiently within the confines of existing Standards; and

(d) the matter is sufficiently narrow in scope that the IASB or Committee can address it in an efficient manner, but not so narrow that it is not cost-effective for the IASB or Committee and stakeholders to undertake the due process required to change an Accounting Standard.

Two main feedback topics (ESG-linked features and CLIs)

26. In the staff view, the significant volume of feedback and nature of application questions relating to the two main feedback topics (ESG-linked features and CLIs—see paragraph 20 of this paper), indicates that standard-setting—rather than interpretation—could be needed in these areas.

27. For these two topics, many respondents said that despite significant discussion in practice, stakeholders cannot reach consensus and feel strongly that additional application guidance is needed. No respondents said that the requirements are clear. Therefore, Agenda Paper 3B and Agenda Paper 3C include staff analysis and preliminary views on whether the IASB should consider standard setting.

Other feedback topics

28. Six other application questions were raised by a few respondents (see paragraph 21 of this paper). For each of those questions, the following tables:

    (a) summarise the requirements to which the question relates;

    (b) explain the question;

    (c) provide staff analysis and recommendations on whether—and what—action the IASB could take in response to the question.

29. A summary of the staff recommendations and a question for the IASB are provided on page 2 of this paper.

A. Non-recourse features and credit risk versus asset-performance risk

Requirements
Some financial assets limit a creditor's claim to specified assets of the debtor or the cash flows from specified assets (that is, some financial assets have a non-recourse feature). Some such financial assets may represent an investment in particular assets or cash flows and hence do not have SPPI cash flows. Paragraph B4.1.17 of IFRS 9 explains: …the fact that a financial asset is non-recourse does not in itself necessarily preclude the financial asset from [having SPPI cash flows]. In such situations, the creditor is required to assess ('look through to') the particular underlying assets or cash flows to determine whether the contractual cash flows of the financial asset being classified are payments of principal and interest on the principal amount outstanding. If the terms of the financial asset give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest, the financial asset does not [have SPPI cash flows]. Whether the underlying assets are financial assets or non-financial assets does not in itself affect this assessment.
Application question
A few respondents noted that financial assets often include a non-recourse feature that comes into effect only when the borrower is in financial difficulty, and the lender's ability

to collect the contractual cash flows then depends on the cash flows generated by the specified asset(s). For such financial assets, those respondents asked how to distinguish between credit risk of the borrower and asset-performance risk when assessing whether the financial asset represents an investment in particular assets.

Example scenarios for which respondents expressed the view that guidance is needed include:

1. A bank issues a loan to a company to finance a construction project. In the event the company cannot repay the loan, the bank's claim is limited to the proceeds from the sale of the construction, which may be lower than the outstanding loan balance.
2. A bank purchases a credit-impaired loan that is secured against a building. At the purchase date, the level of impairment is such that it is reasonably likely that the only cash flows the bank will receive will be the proceeds from the sale of the building, which is expected to be much lower than the outstanding loan balance.
3. A bank issues a loan to a special purpose entity that has only a limited set of assets. The contract does not include a non-recourse feature; however the nature of the borrower means that the repayment of the loan would directly depend on the performance of the specific assets.

Staff analysis

Many financial assets are collateralised by financial or non-financial assets. The staff observe that some respondents appear to have interpreted paragraph B4.1.17 of IFRS 9 as requiring an entity to determine that a financial asset does not have SPPI cash flows if it is collateralised by an asset that does not generate SPPI cash flows. That was not the IASB's intention.

The objective of paragraphs B4.1.15–B4.1.17 in IFRS 9 is to require the holder of a financial instrument to assess the nature of the cash flows and what the holder is being compensated for, rather than simply relying on how those cash flows are described or labelled in the contract.

The staff think there is a difference between cases in which the payments of the principal and interest rely on the cash flows generated by the underlying assets in the normal course of business versus cases in which these payments are made out of the underlying assets only if the borrower cannot make repayments. In the staff view, a non-recourse financial asset refers to a financial asset for which (1) the repayment of the loan is wholly dependent on the cash flows generated by a particular asset(s); and (2) the lender has no recourse to the entity (ie no claim) in the event of default except for any cash flows arising from liquidating the particular asset.

The extent of the analysis required to determine what the holder is being compensated for depends on facts and circumstances. In some cases, entities may be able to conclude with little analysis, while in other complex transactions, a more rigorous analysis would be required. We think the need for analysing contractual terms is inevitable to apply accounting requirements that consider the characteristics of the contractual cash flows. It is also inevitable that a more extensive analysis is required for more complex contracts.

The staff think that the use of the phrase ‘to look through’ in paragraph B4.1.17 of IFRS 9 may be the reason some respondents are questioning how to apply the requirements. Respondents have drawn a similarity to the requirements for CLIs which also require an entity to ‘look through’ to the underlying pool of instruments. In feedback on CLIs, many respondents expressed confusion about the difference between the requirements in paragraph B4.1.17 of IFRS 9 and the requirements for CLIs.

In Agenda Paper 3C the staff express a preliminary view that the IASB could consider standard setting for CLIs. If the IASB decides that standard-setting is needed for CLIs, the staff recommend that as part of that project, the IASB consider clarifying the requirements for non-recourse features. Our view is that clarifying the requirement would be relatively simple and would support consistent application and benefit the many respondents that raised questions about the difference between non-recourse and CLIs.

Recommendation: consider with analysis of CLIs (see Agenda Paper 3C)

B. Bail-in legislation included in the contract

Requirements
Paragraph B4.1.13 of IFRS 9 describes ‘Instrument E’ as an example of a financial asset with SPPI cash flows:

> Instrument E is issued by a regulated bank and has a stated maturity date. The instrument pays a fixed interest rate and all contractual cash flows are non-discretionary.
>
> However, the issuer is subject to legislation that permits or requires a national resolving authority to impose losses on holders of particular instruments, including Instrument E, in particular circumstances. For example, the national resolving authority has the power to write down the par amount of Instrument E or to convert it into a fixed number of the issuer's ordinary shares if the national resolving authority determines that the issuer is having severe financial difficulties, needs additional regulatory capital or is 'failing'.

Paragraph B4.1.13 of IFRS 9 explains that the holder would analyse the contractual terms of the instrument, and would not consider payments that arise only as a result of the national resolving authority's power to impose losses on the holders of Instrument E. That is because the power, and the resulting payments, are not contractual terms of the financial instrument. In contrast, the contractual cash flows would not be SPPI if the contractual terms of the instrument permitted or required the issuer or another entity to impose losses on the holder.

Application question

A few respondents asked whether an entity needs to consider the cash flows arising from bail-in legislation if such legislation is reproduced in the contract. One respondent said inconsistent application could arise with regards to drawing a line between whether such a term included in a contract is merely acknowledgement of the rights and obligations arising from legislation or introduces additional rights and obligations as part of the contractual terms.

Staff analysis

The IASB is aware that this question has been raised for a number of years. The staff note the IASB's recent discussion on the interaction of laws and the contractual terms as part of its FICE project. As part of that discussion, the IASB tentatively decided to make a clarification to IAS 32 on how an entity considers the effects of law on the contractual terms. Although the IASB's decision was specific to how the issuer of financial

instruments classifies them as financial liabilities or equity, the staff think the IASB could consider making similar clarification to IFRS 9 once it considers feedback on the proposal. Therefore, the staff recommend that the IASB consider this feedback subsequent to further development in the FICE project. **Recommendation: consider subsequent to further development in the FICE project**

C. Contractual inflation adjustments and leverage

Requirements
Paragraph B4.1.9 of IFRS 9 explains: Leverage is a contractual cash flow characteristic of some financial assets. Leverage increases the variability of the contractual cash flows with the result that they do not have the economic characteristics of interest. Stand-alone option, forward and swap contracts are examples of financial assets that include such leverage. Thus, such contracts do not [have SPPI cash flows] and cannot be subsequently measured at amortised cost or fair value through other comprehensive income.
Application question
Some respondents asked whether interest rates that are contractually adjusted for inflation introduce leverage. In Latin America for example, it is common for the interest rate of financial instruments to be contractually linked to an index that adjusts the time value of the money based on a market interest rate and/or inflation rate. Some respondents expressed the view that linking principal and interest payments to such an index results in a ‘current level’ time value or money (ie the ‘real’ interest rate). However, questions have arisen as to whether such adjustments introduce leverage in the context of recent significant rises in inflation rates.
Staff analysis
In developing IFRS 9, the IASB explicitly considered contractual cash flows linked to an inflation index. As a result, IFRS 9 includes an example of how an entity analyses whether an inflation index-linked bond has SPPI cash flows. It explains that linking contractual cash flows to an unleveraged inflation index resets the time value of money to a current

level and the interest amounts are consideration for the time value of money on the principal amount outstanding. The staff think this conclusion remains relevant regardless of the level of inflation. In our view, IFRS 9 is clear in this regard.

However, given that we are not aware of this question being raised since IFRS 9 was issued, we are not aware of whether there is diversity in practice with a widespread or material effect. Therefore, we recommend that the IASB seek input from ASAF and Interpretations Committee members as to whether based on their experience this question could meet the criteria of the IFRS Interpretations Committee.

Recommendation: seek input from ASAF and Interpretation Committee members

D. Regulated interest rates and leverage

Requirements

Paragraph B4.1.9E explains:

> In some jurisdictions, the government or a regulatory authority sets interest rates. For example, such government regulation of interest rates may be part of a broad macroeconomic policy or it may be introduced to encourage entities to invest in a particular sector of the economy. In some of these cases, the objective of the time value of money element is not to provide consideration for only the passage of time. However, despite paragraphs B4.1.9A–B4.1.9D, a regulated interest rate shall be considered a proxy for the time value of money element for the purpose of [assessing whether cash flows are SPPI] if that regulated interest rate provides consideration that is broadly consistent with the passage of time and does not provide exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement.

Application question

A few respondents said that in their jurisdictions, financial instruments with regulated interest rates can include a leverage factor imposed by the government. These respondents asked how to consider such a leverage factor in assessing whether the interest rate is a regulated interest rate applying paragraph B4.1.9E of IFRS 9, and if it is, how to consider whether the rate provides exposure to risks or volatility in the contractual cash flows that are inconsistent with a basic lending arrangement applying paragraph B4.1.9E of IFRS 9.

In Hungary and Poland for example, a leverage factor is imposed by the government for a particular type of loans granted as part of a government scheme. For example, the interest rate of the loans is determined based on 1.3*government bond yield at disbursement + margin. According to a banking industry body in Hungary, the government pays 1.3*government bond yield in the form of interest subsidy and the borrower pays the margin. In determining the factor of 1.3, the government considered that in the local market the mortgage-backed securities have historically traded at 30% premium over the government bond rate.

Respondents noted diversity in practice in making this assessment, resulting in some entities measuring the financial assets at amortised cost, whilst other entities measure the same financial assets at fair value through profit or loss. A respondent reported that as of 31 December 2021, this type of loan in the Hungarian market amounted to approximately EUR 4 billion and is expected to grow to EUR 6.85 billion by the end of 2022. One of the largest banks in Eastern Europe said that this type of loans accounted for 90% of their loans measured at fair value through profit or loss.

Staff analysis

In the staff view, the nature of this question is such that it may be suitable to submit to the IFRS Interpretations Committee. The feedback indicates that diversity in practice exists and that there could be a material effect in specific jurisdictions. To consider whether the question should be referred to the Interpretations Committee, we think it could be helpful to understand whether this matter has widespread and material effect in other jurisdictions.

Therefore, we recommend that the IASB seek input from ASAF and Interpretations Committee members as to whether based on their experience this question could meet the criteria of the IFRS Interpretations Committee.

Recommendation: seek input from ASAF and Interpretation Committee members

E. Prepayment features and reasonable compensation

Requirements
Paragraph B4.1.11 of IFRS 9 provides the following as an example of contractual terms that result in SPPI cash flows: (b) a contractual term that permits the issuer (ie the debtor) to prepay a debt instrument or permits the holder (ie the creditor) to put a debt instrument back to the issuer before maturity and the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding, which may include **reasonable compensation** for the early termination of the contract;
Application question
A few respondents asked, 'what is reasonable compensation?' One respondent that asked this question expressed the view that judgement is required to determine 'reasonable compensation' depending on specific facts and circumstances associated with a transaction. Other respondents said that there are diverse views in practice about what is considered to be reasonable compensation and asked for application guidance, for example, a list of factors that an entity could consider when assessing 'reasonable compensation', and guidance on the circumstances under which an entity is required to consider the fair value of the prepayment feature.
Staff analysis
The staff agree that an entity needs to consider the specific facts and circumstances to determine whether a prepayment clause includes 'reasonable compensation' for early termination. We note that IFRS Accounting Standards often require an entity to apply judgement depending on the facts and circumstances, for example to determine if something is 'reasonable', 'significant' or 'substantial'. The key consideration in this circumstance is whether the contractual cash flows that could arise over the life of the instrument due to that contractual term are SPPI. This includes consideration of *what* the entity is being compensated for as required by paragraph B4.1.7A of IFRS 9. Paragraph B4.1.12 of IFRS 9 describes circumstances in which a prepayable financial asset would be eligible to be measured at amortised cost (or fair value

through OCI), which includes that the fair value of the prepayment feature is insignificant when the financial assets is initially recognised. The staff think the principle in IFRS 9 is clear in this regard. The staff note that the IASB was already made aware of this question as part of the 2017 Prepayment Features with Negative Compensation project. The IASB decided not to address the question as part of that project, and outreach since then has indicated that practice has since been established without evidence of diversity with a widespread or material effect. The staff also note that the PIR feedback raised in this area is relatively general/high-level, without specific examples of fact patterns or explanations of divergent views that exist in practice. Based on the information received, the staff view is that this question would not meet the criteria for discussion by the IFRS Interpretations Committee. Therefore, the staff recommend that the IASB take no further action for this application question. We note that stakeholders can choose to submit the application question to the IFRS Interpretations Committee if they have further information that they believe could indicate the question meets the criteria for discussion by the Interpretations Committee. **Recommendation: no further action**

F. Modified time value of money and administrative rates

Requirements
Paragraphs B4.1.9B and B4.1.9C explain: …in some cases, the time value of money element may be modified (ie imperfect). That would be the case, for example, if a financial asset's interest rate is periodically reset but the frequency of that reset does not match the tenor of the interest rate (for example, the interest rate resets every month to a one-year rate) or if a financial asset's interest rate is periodically reset to an average of particular short- and long-term interest rates. In such cases, an entity must assess the modification to determine whether the contractual cash flows represent solely payments of principal and interest on the principal amount outstanding. In some circumstances, the entity may be able to make that determination by performing a

qualitative assessment of the time value of money element whereas, in other circumstances, it may be necessary to perform a quantitative assessment.

When assessing a modified time value of money element, the objective is to determine how different the contractual (undiscounted) cash flows could be from the (undiscounted) cash flows that would arise if the time value of money element was not modified (the benchmark cash flows).

Application question

A few respondents asked whether particular types of interest rates, for example compounded risk-free rates, include a modified time value of money element. These respondents explained that as a result of IBOR reform, some IBOR-based rates were replaced with overnight risk-free rates. The overnight risk-free rate is typically compounded over a longer tenor (e.g. one month) in lending arrangements. Some respondents said it is not clear whether:

(a) the time value of money is always considered to be modified for compounded risk-free rates; or

(b) compounding an overnight risk-free rate over one month makes the compounded risk-free rate a rate with a one-month tenor such that the time value of money is not modified, if reset in accordance with that frequency.

A standard-setter in Europe raised a similar question about financial instruments with administrative rates. According to the respondent, the contractual terms of some financial instruments refer to ‘the general interest level’. In practice, that means that a ‘composite’ rate is created using the composition of the actual funding of the lender. The respondent noted that while there is no concern about the classification outcome, a significant level of analysis is required to determine the classification. The respondent requested the IASB consider providing application guidance in IFRS 9 or educational material on how to assess whether administrative rates are consistent with SPPI.

Staff analysis

In developing IFRS 9, the IASB discussed the relationship between the consideration of time value of money and principal. As a result, IFRS 9 contains detailed application guidance on how to assess the time value of money element of interest. As reproduced above, the IASB acknowledged that some financial assets with an imperfect economic relationship between principal and the consideration for the time value of the money can have SPPI cash flows. Paragraphs B4.1.9B–B4.1.9D of IFRS 9 provide detailed application guidance on how an entity assess such financial assets. The staff think the principle in IFRS 9 in this regard is clear and the application guidance sufficient.

The staff note that the IASB was already made aware of this question as part of the 2020 IBOR Reform—Phase 2 project. The IASB decided not to address the question as part of that project, and outreach since then has indicated that practice has since been established without evidence of diversity with a widespread or material effect.

The staff also note that the feedback raised in this area is relatively general/high-level, without specific examples of fact patterns or explanations of divergent views that exist in practice.

Based on the information received, the staff view is that this question would not meet the criteria for discussion by the IFRS Interpretations Committee. Therefore, the staff recommend that the IASB take no further action for this application question. We note that stakeholders can choose to submit the application question to the IFRS Interpretations Committee if they have further information that they believe could indicate the question meets the criteria for discussion by the Interpretations Committee.

Recommendation: no further action